

No. 12660

In The United States Court of Appeals
For the Ninth Circuit

HARBOR PLYWOOD CORPORATION,
a Corporation, *Petitioner,*

VS

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

UPON PETITION TO REVIEW A DECISION OF
THE TAX COURT OF THE
UNITED STATES

PETITIONER'S BRIEF

WARREN A. DOOLITTLE,
Attorney for Petitioner.

657-671 Colman Building,
Seattle 4, Washington.

THE ARGUS PRESS, SEATTLE

FILED

DEC - 4 1950

PAUL P. O'BRIEN

No. 12660

In The United States Court of Appeals
For the Ninth Circuit

HARBOR PLYWOOD CORPORATION,
a Corporation, *Petitioner,*

VS

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

UPON PETITION TO REVIEW A DECISION OF
THE TAX COURT OF THE
UNITED STATES

PETITIONER'S BRIEF

WARREN A. DOOLITTLE,
Attorney for Petitioner.

657-671 Colman Building,
Seattle 4, Washington.

INDEX

	<i>Page</i>
Opinion Below	1
Jurisdiction	1
Statement of the Case and Questions Involved.....	3
Assignments of Error.....	6
Argument	9
A. The true rule of accrued income governs the case at bar and is as follows: Income accrues to a taxpayer when there arises to him a fixed or unconditional right to receive it and where there is no contingency or uncertainty that may preclude ultimate payment; that no income accrues unless there is a reasonable expectancy that the right will be converted into money and that no such reasonable expectancy can exist so long as there is an unresolved and allegedly intervening legal right which makes receipt contingent (Assignments of Error I, II, IV)	9
B. The Tax Court erred in its opinion in stating that the threat of renegotiation was a "mere possibility of renegotiation". Such statement is contrary to the evidence. Such renegotiation was not only possible but highly probable (Assignment of Error III)	33
C. The Tax Court erred in relying on the cases dealing with patronage dividends by cooperatives (R. 131), none of which cases were concerned with a threatened or actual renegotiation of a cooperative's income under the Renegotiation Act of 1942 (Assignment of Error VI).....	39
D. The Tax Court erred in considering that the method of accounting and the time for deducting expenses by Pacific Forest Industries is in any way determinative of the method of accruing and the time for reporting income by the taxpayer, Harbor Plywood Corporation (Assignment of Error V)	41

- The Tax Court further erred in failing to recognize that, notwithstanding that the taxpayer, Harbor Plywood Corporation, is an accrual basis taxpayer, certain of the concepts in cases decided under the principle of "constructive receipt" of income by cash basis taxpayers are relevant and persuasive by way of analogy to the case at bar (Assignment of Error VII)..... 41
- E. The Tax Court erred in failing to realize and to find that, in addition to the fact that Pacific Forest Industries issued each credit memorandum "subject to renegotiation," no reasonable expectancy that the right represented by such memorandum would be converted into money could exist so long as the unresolved and intervening legal right as was created by the Renegotiation Act itself was not barred by the Statute of Limitations (Assignment of Error IX-b) 43
- F. The Tax Court erred in failing to find that the credits from Pacific Forest Industries were not taxable income to the taxpayer, Harbor Plywood Corporation, until paid in cash (Assignment of Error IX) 45
- G. The Tax Court erred in failing to find, in the alternative, under the true rule of accrued income set forth above that when the credit memoranda were issued, the taxpayer had no fixed and unconditional right to the amount of each memorandum because at each such time
- (a) there was a contingency which might preclude ultimate payment, namely, the possible and probable renegotiation of Pacific Forest Industries;
 - (b) No reasonable expectancy that the right would be converted into money could exist so long as such unresolved and intervening legal right as was created by the Renegotiation Act itself was not barred by the statute of limitations; and

(c) There was a further contingency which precluded payment imposed by Pacific Forest Industries itself, namely, the fact that it notified the taxpayer in writing, as The Tax Court properly found for each year, that each credit memorandum was issued "subject to Renegotiation";

and therefore, the amounts represented by said credit memoranda could not be accrued as taxable income by the taxpayer, Harbor Plywood Corporation, until the statute of limitations barred the Renegotiation of Pacific Forest Industries' income (Assignment of Error IX).....45-46

H. The Tax Court erred in making and entering its decision of April 25, 1950 (Assignment of Error VIII) 46

Conclusion 47

Appendix A 51

Statutes and Regulations Involved

TABLE OF CASES

Bluthenthal, 1 B.T.A. 173 42

Cuba Railroad Company, The (1947)

9 T. C. 21122, 27, 28

Farr, 3 B.T.A. 110..... 42

Fifth Street Store (1946) 6 T. C. 644.....22, 25

Greenbaum, 2 B.T.A. 979..... 42

Georgia School Book Depository, Inc. v.

Commissioner, 1 T. C. 463.....22, 24

Helvering v. Jane Holding Corp. (C.C.A. 8)

109 F. (2d) 933..... 42

H. Liebes & Company v. Commissioner (C.C.A. 9)

90 F. (2d) 932, 34 B.T.A. 677.....10, 11, 12, 13, 17, 18
21, 22, 30, 31, 32

Karr, 2 B.T.A. 635..... 42

Luckenbach Steamship Co., 9 T. C. 662..... 28

Midland Cooperative Wholesale, 44 B.T.A. 824..... 40

Petit, William Justin (1947) 8 T. C. 228.....22, 27, 28

	<i>Page</i>
<i>San Francisco Stevedoring Co.</i> (1947)	
8 T. C. 222.....	22, 25, 26, 27
<i>San Joaquin Valley Poultry Producers Association</i> ,	
136 F. (2d) 382.....	39, 40
<i>Smith, Lester C. (deceased), Mary B. W. Smith,</i>	
<i>Testamentary Executrix v. Commissioner, and</i>	
<i>Smith, Mary B. W. v. Commissioner</i> (1949) 8	
T.C.M. 385	22, 28, 30, 31, 41
<i>Spring City Foundry Co. v. Commissioner</i> ,	
292 U. S. 182.....	11, 22, 23
<i>United Cooperatives, Inc.</i> , 4 T.C. 93.....	40
<i>U. S. v. Safety Car Heating and Lighting Co.</i> ,	
297 U. S. 88.....	22
<i>Weil v. Commr.</i> (C.C.A. 2) 173 F. (2d) 805.....	45

TEXTBOOKS

Mertens, "Law of Federal Income Taxation," Vol 2	
(and 1950 Cum. Pocket Supp.) §§12.60-12.65;	
§§12.75-12.77	32
Rabkin and Johnson, "Federal Income, Gift and	
Estate Taxation," pp. 704, 707-8, 709b, 712.....	32

STATUTES

Internal Revenue Code, § 22(a)	9, 51
§ 41	9, 51
§ 42(a)	9, 52
§ 1141	2
§ 1142	2
Renegotiation Act of 1942.....	6, 7, 10, 38, 43, 45

REGULATIONS

Regulations 111, § 29.22(a)-1	9, 52
§ 29.22(a)-5	9, 52
§ 29.41-1	9, 53
§ 29.42-1	9, 53
§ 29.42-2	9, 54

Bureau of Internal Revenue, L.O. 1086, 1-1 CB 87....	32
--	----

In The United States Court of Appeals
For the Ninth Circuit

<p>HARBOR PLYWOOD CORPORATION, a Corporation, <i>Petitioner,</i> <div style="text-align: center;">vs.</div> COMMISSIONER OF INTERNAL REVENUE, <i>Respondent.</i></p>	}	No. 12660
---	---	-----------

UPON PETITION TO REVIEW A DECISION OF
THE TAX COURT OF THE
UNITED STATES

PETITIONER'S BRIEF

OPINION BELOW

The previous opinion and dissenting opinion in this case is the opinion of The Tax Court of the United States, 14 T.C. No. 20, Docket No. 20729, promulgated January 31, 1950 (R. 124-133).

JURISDICTION

This is a proceeding to review a decision of The Tax Court of the United States entered herein on April 25, 1950, which decision approved the deficiencies determined by the Commissioner of Internal Revenue in excess profits taxes of \$95,028.66 and \$17,407.58 for 1943 and 1944, respectively, and a deficiency of \$24,219.57 in income tax for 1945 (R. 139).

From respondent's determination of proposed deficiencies for each of said years a petition was filed with

The Tax Court of the United States (R. 4-11), which petition, pursuant to leave of said Tax Court, was amended by the service and filing of an amendment to said petition (R. 19-22). Said case was heard before the Honorable C. P. Le Mire, Judge of The Tax Court, on June 14, 1949, and the findings of fact and opinion in the cause were promulgated on January 31, 1950 (R. 124-133). The agreed computation by the parties for entry of decision was filed April 21, 1950, and the decision of The Tax Court thereon was entered on April 25, 1950.

The petitioner is a corporation duly organized and existing under the laws of the State of Delaware, and has its principal place of business at Hoquiam, Washington.

The petitioner filed its income and excess profits tax returns for the years in question, namely, the taxable calendar years 1943, 1944 and 1945, with the Collector of Internal Revenue for the Washington District, which office is situated in the City of Tacoma, State of Washington, and is located within the jurisdiction of the United States Court of Appeals for the Ninth Circuit where this review is sought pursuant to the provisions of Internal Revenue Code, Sections 1141 and 1142 (R. 144).

This appeal was taken by Petition For Review filed July 17, 1950 (R. 147) and notice of such filing served on respondent on July 17, 1950 and filed July 26, 1950 (R. 148).

This Court has jurisdiction under Sections 1141 and 1142 of the Internal Revenue Code.

STATEMENT OF THE CASE**and****QUESTIONS INVOLVED**

This case presents the very simple question as to the proper time for the reporting of income by the petitioner, Harbor Plywood Corporation, an accrual basis taxpayer. The income in question consists of three separate refunds received by the taxpayer from Pacific Forest Industries, a corporation engaged solely in the export of plywood and other forest products for its member stockholders. The taxpayer at all times material was a member stockholder in Pacific Forest Industries. The taxpayer was and is in the business of manufacturing and distributing plywood, doors and building material. It makes no sales in the export trade of its plywood or other forest products; instead its exports are marketed through Pacific Forest Industries, the latter being a corporation authorized by the Webb Export Trade Act. During each of the taxable years, 1943, 1944 and 1945, Pacific Forest Industries, pursuant to its by-laws, issued to the taxpayer a credit memorandum, representing the taxpayer's pro-rata share of the excess of Pacific Forest Industries income over its expenses for the year, and the amounts of each credit memorandum were credited to the taxpayer on the books of account of Pacific Forest Industries. Similar credit memorandum were issued to the other 18 companies who were stockholder members. At all times involved in this case Pacific Forest Industries was threatened in writing with the actual renegotiation of its profits by the Treasury Department Procure-

ment Division handling lend-lease contracts as provided by the Renegotiation Act of 1942. Because of this threat each credit memorandum issued to the taxpayer and the other members for each year was issued subject to the possible renegotiation of Pacific Forest Industries; that is to say, the Pacific Forest Industries notified the taxpayer and the other stockholder members as the credit memoranda were issued for each year, that it would not distribute the additional amounts represented by the credit memoranda until it had been settled whether or not Pacific Forest Industries was subject to renegotiation as the Government was contending.

The renegotiation of Pacific Forest Industries for its fiscal years ended 1943, 1944 and 1945, was barred by the running of the statute of limitations on the dates of March 31, 1944, May 11, 1945, May 29, 1946, respectively. Pacific Forest Industries paid the credit memoranda issued to the taxpayer for 1943, 1944, and 1945 in cash on the dates of December 12, 1944, January 29, 1946, and July 23, 1946, respectively. The delay of these payments beyond the dates of expiration of the statute of limitations on renegotiation for each year was due to the fact that Pacific Forest Industries had not collected for all of its sales (all of which were made to the Government for Lend-Lease) and did not have sufficient cash on hand to make the payments sooner.

The taxpayer reported the income represented by the credit memoranda in the years when it received the cash payments on them. The Commissioner of Internal Revenue determined that the amounts should

have been accrued as income and were taxable to the taxpayer when each credit memorandum was received. Both parties in the Tax Court made the alternative contention that the running of the statute of limitations on renegotiation of Pacific Forest Industries determined the time of accrual and the time for reporting as taxable income each of the credit memoranda by the taxpayer, Harbor Plywood Corporation.

The Tax Court held, and the taxpayer disagrees with the holding, that the amounts represented by the credit memoranda accrued and were taxable to the taxpayer, Harbor Plywood Corporation, in the years when the credit memoranda were issued, notwithstanding that the Tax Court also found that they were issued expressly "subject to Renegotiation."

The controversy before this Court involves the following questions:

1. Was the Tax Court correct in holding that the amounts represented by the credit memoranda which were expressly issued "subject to Renegotiation," constituted a part of the taxable income of the taxpayer, Harbor Plywood Corporation, and should have been accrued in the taxable year in which each credit memorandum was issued by Pacific Forest Industries? or

2. Should the amounts represented by each credit memorandum have been accrued and have been taxable to Harbor Plywood Corporation for the year during which the statute of limitations expired on the renegotiability of Pacific Forest Industries, as contended in the alternative by both parties? or

3. Should the amounts of the credit memoranda have been reported as income for the year in which each credit memorandum was paid in cash to the taxpayer by Pacific Forest Industries?

ASSIGNMENTS OF ERRORS

The petitioner assigns as errors the following acts and omissions of The Tax Court of the United States:

1. The conclusion of the Tax Court of the United States that the amounts represented by the credit memoranda issued to the taxpayer, Harbor Plywood Corporation, in each of the taxable years by Pacific Forest Industries accrued and were taxable to the taxpayer in the year of their issuance, notwithstanding that they were issued, as the Tax Court properly found, "subject to renegotiation" for all years.

2. The holding of the Tax Court of the United States that when the credit memoranda were issued subject to renegotiation there was no contingency as to the amount of income represented by the credit memoranda or of Harbor's right to receive it.

3. The opinion of the Tax Court that the threat of renegotiation was a "mere possibility of renegotiation," as being contrary to the evidence.

4. The opinion of the Tax Court that the "mere possibility" of the renegotiation of Pacific Forest Industries under the Renegotiation Act of 1942 had no effect upon Harbor Plywood Corporation's duty to accrue the income represented by the credit memoranda which were issued with notice that they were issued subject to renegotiation.

5. The opinion of the Tax Court that the method of accounting and the time for deducting expenses by Pacific Forest Industries is in any way determinative of the method of accruing and the time for reporting income by the taxpayer, Harbor Plywood Corporation.

6. The reliance of the Tax Court on the cases dealing with patronage dividends by cooperatives, none of which were concerned with a threatened or an actual renegotiation of a cooperative's income under the Renegotiation Act of 1942.

7. The failure of the Tax Court of the United States to recognize that, notwithstanding that the taxpayer is an accrual basis taxpayer, certain of the concepts and cases decided under the principle of "constructive receipt" of income by cash basis taxpayers are relevant and persuasive by way of analogy.

8. The making and entry by the Tax Court of the United States of its decision of April 25, 1950.

9. The failure of the Tax Court to find that these credits from Pacific Forest Industries were not taxable income to taxpayer, Harbor Plywood Corporation, until paid in cash; or, in the alternative, the failure of the Tax Court to find, under the true rule of "accrued income," that when the credit memoranda were issued, the taxpayer had no fixed and unconditional right to the amount of each memorandum because at such time

(a) there was a contingency which might preclude ultimate payment, namely, the possible Renegotiation of Pacific Forest Industries;

(b) no reasonable expectancy that the right

would be converted into money could exist so long as such unresolved and intervening legal right as was created by the Renegotiation Act itself was not barred by the statute of limitations; and

(c) there was the further contingency which precluded payment imposed by Pacific Forest Industries itself, namely, the fact that it notified the taxpayer in writing that each credit memorandum was issued "subject to renegotiation;"

and, therefore, the amounts represented by said credit memoranda could not be accrued as taxable income by the taxpayer, Harbor Plywood Corporation, until the statute of limitations barred the Renegotiation of Pacific Forest Industries' income.

ARGUMENT

A.

The true rule of accrued income governs the case at bar and is as follows: Income accrues to a taxpayer when there arises to him a fixed or unconditional right to receive it and where there is no contingency or uncertainty that may preclude ultimate payment; that no income accrues unless there is a reasonable expectancy that the right will be converted into money and that no such reasonable expectancy can exist so long as there is an unresolved and allegedly intervening legal right which makes receipt contingent. (Assignments of Error I, II, IV.)

None of the three credit memoranda issued by Pacific Forest Industries to Harbor Plywood Corporation were taxable income to Harbor Plywood Corporation under Internal Revenue Code, Sections 22 (a), 41 and 42 (a) and the regulations thereunder (See Appendix A) at the date of their issuance. Under the application of the true rule of accrued income above stated and according to the stipulated facts in this case and the finding of fact of The Tax Court with which the petitioner is in complete agreement, namely, that each credit memorandum was issued subject to the same restriction as to payment, namely, it was issued "subject to Renegotiation" (R. 128), the taxpayer, Harbor Plywood Corporation, had no fixed and unconditional right to the amount of each Pacific Forest Industries' credit memorandum when each memorandum was issued because at such time there was a contingency which might preclude ultimate payment, namely, the possible Renegotiation of Pacific Forest Industries

under the Renegotiation Act of 1942; that no reasonable expectancy that the right would be converted into money could exist so long as such unresolved and allegedly intervening legal right as was created by the Renegotiation Act itself was not barred by the statute of limitations. In addition, there was the contingency which precluded payment and which was imposed by Pacific Forest Industries itself at the time each credit memorandum was issued, namely, as The Tax Court properly found, the fact that each memorandum was issued "subject to Renegotiation," and as such, the taxpayer's right to each memorandum was conditional and not accruable. This, then, is the crux of this case.

The evolution and development of this true rule of accrued income apparently escaped The Tax Court in its deliberations notwithstanding the careful presentation of its development by the petitioner. The Tax Court failed to realize and to apply the fundamental corollary of such true rule, namely, that such conditional or contingent income cannot be taxed until it is shorn of its conditional or contingent quality and has become unconditional or absolute.

This Ninth Circuit Court of Appeals has already agreed with the above stated true rule of accrued income in the cases of *H. Liebes and Co. v. Commissioner*, 90 F. (2d) 932, affirming 34 B.T.A. 677. It is true that The Tax Court in its opinion (R. 129-130) recognized and quoted from the *Liebes* case, but it is submitted that it misapplied the principle. Therefore, petitioner believes it necessary to make a review to this court of the cases properly setting forth this rule.

The most frequently cited case is *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, where the United States Supreme Court said:

“Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, imports that it is the right to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues.”
(Pages 184-5)

To properly decide the case at bar it is actually necessary to cite only one additional case, namely the *Liebes* case referred to above, decided, as previously mentioned, by this Ninth Circuit Court of Appeals. The *Liebes* case contains a thorough review of all the leading cases on the subject and therefore will be quoted extensively below in this brief, thus eliminating the necessity of encumbering this brief with numerous citations and quotations.

That case involved litigation, which was authorized by statute, against the United States. The petitioner in that case had obtained a judgment in 1928, but the appeal period did not expire and no funds were available to pay the judgment until the end of the petitioner's fiscal year ending January 31, 1930, when it received payment. The petitioner had argued that the amounts were properly reportable on an accrual basis in the years in which the judgment was rendered, which was prior to the taxable year. The court held that such was not the case and the items could not be accrued in any prior year, but rather were reportable only when

the time for appeal had expired and when the amounts were paid. The Court of Appeals affirmed.

Before considering the language of the Circuit Court in the *Liebes* case, it is well to consider the language of the Board of Tax Appeals on this point which is particularly pertinent and is as follows:

“ ‘A mere contingent claim, especially a contested one, whether of gain or loss, may never be sustained or realized; it is too uncertain to be considered in making up an income tax return.’ *Commissioner v. Southeastern Express Co.*, 56 Fed. (2d) 600. To the same effect are *Commissioner v. Brown*, 54 Fed. (2d) 563, and *Buffalo Union Furnace Co. v. Helvering*, 72 Fed. (2d) 399. All of these cases involved sums concerning which there was litigation and the substance of the holdings is that during litigation the taxpayer’s rights were too uncertain to warrant accrual. We do not read the case of *Lichtenberger-Ferguson Co. v. Welch*, 54 Fed. (2d) 570, as opposed to the decisions above cited. In that case the taxpayer was awarded a sum by the War Department in 1919 for cancellation of a war contract. Due to some confusion in the War Department the check covering the award was not received by the taxpayer until 1920. There was no dispute or litigation concerning the award after it was made by the War Department, and the court, finding that ‘the adjustment made in August, 1919, was a final adjustment,’ held it to be accrued income in 1919. Similarly, in *Automobile Insurance Co. v. Commission*, 72 Fed. (2d) 265, the taxpayer accrued in 1928 the amount of an award by the Mixed Claims Commission, United States and Germany. It received a substantial payment on the award in that year, and it does not appear that

there was any contest, litigation, or other contingency respecting the taxpayer's right to the amount awarded. The Circuit Court sustained the accrual in 1928, quoting *Spring City Foundry Co. v. Commissioner*, 292 U. S. 192, that 'it is the right to receive and not the actual receipt that determines the inclusion of the amount in gross income.' Here the taxpayer's 'right to receive' was not established until February, 1929, which was within its fiscal year ended January 31, 1930.

"In No. 17541 suit was brought directly by the petitioner and judgment was rendered for the petitioner on December 28, 1928. The parties stipulate that no appeal was taken by the United States. However, they do not stipulate that any final settlement or agreement not to appeal was reached within the petitioner's fiscal year 1929. The appeal period of three months (§226, 230 U.S.C.A.) did not expire until in petitioner's fiscal year ended January 31, 1930, and in the absence of any act by the parties the judgment would not become final until the expiration of that period. At the time the judgment was rendered there was no appropriation available to satisfy it, and the funds were not appropriated until in petitioner's fiscal year ended January 31, 1930. Under these circumstances we are of the opinion that this judgment, like the others, was surrounded by too many contingencies and uncertainties to warrant. Apparently the petitioner thought so too, as it did not accrue any of the items on its books and did not accrue any of the items on its books and did not report them as income in the years in which it now says they were accruable." (pp. 682-683)

The Ninth Circuit Court of Appeals, in the *Liebes*

case, affirmed the Board of Tax Appeals and, in considering the same question which this court has before it in the case at bar, namely, when did the income accrue, said (90 F. (2d) 932 at pp. 936-938):

“Fourth. The principal issue is the time when the income accrued. Before discussing the specific contentions, we examine that question.

“It is apparent that the word ‘accrued’ may differ in its meaning, according to its use.

“In 1 Bouv. Law Dict. (Rawle’s Third Rev.) 111, the word ‘acrued’ is defined as follows:

“ ‘To grow to; to be added to; to become a present right or demand * * *

“ ‘To rise, to happen, to come to pass * * * ’

“In 1 C.J.S., Accrued, p. 761, it is said:

“ ‘Accrued,’ as the past tense or preterit of the verb, has been defined as meaning: Acquired; arose; became due; became vested; came into existence; existed; fell due; has arisen; made or executed; matured; occurred; received; vested; was created; was incurred; was in existence * * * ’

“As a general statement, the word ‘arose’ seems most expressive. However, such a general definition must be considered in connection with the use of the word. We must, therefore, determine what is meant by the words ‘income accrued’ as used with reference to income tax returns.

“The act does not define or provide when income accrues. In *United States v. American Can Co.*, 280 U.S. 412, 417, 50 S.Ct. 177, 179, 74 L.ed. 518, it is said that the taxpayers kept their books on ‘the accrual basis—that is, pecuniary obligations payable to or by the company were treated as if discharged when incurred.’ In *Lucas v. North*

Texas Lumber Co., 281 U.S. 11, 13, 50 S.Ct. 184, 185, 74 L.ed. 668, we are informed that income does not accrue until there is 'unconditional liability' on behalf of a party to pay it to the taxpayer. In *Continental Tie & L. Co. v. United States*, 286 U.S. 290, 295, 52 S.Ct. 529, 530, 76 L.ed. 1111, it is indicated that income accrues, when there is a 'right to payment.' In *North American Oil Consol. v. Burnet*, 286 U.S. 417, 424, 52 S.Ct. 613, 615, 76 L.Ed. 1197, it is said: 'If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.' In *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, 184, 54 S.Ct. 644, 645, 78 L.ed. 1200, it is said: 'Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the right to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues.' In *United States v. Safety Car Heating & Lighting Co.*, *supra*, 297 U.S. 88, 93, 94, 56 S.Ct. 353, 356, 80 L.ed. 500, it is indicated that income accrues when the liability is uncontested and certain.

"In *Lichtenberger-Ferguson Co. v. Welch*, (C.C.A. 9) 54 F. (2d) 570, 572, this court said:

" 'Under the accrual system of accounting, where an item is definitely ascertained as to its amount, and acknowledged to be due, it has "accrued." ' To quote from the decision of the United

States Board of Tax Appeals in the case of Appeal of Clarence Schock, 1 B.T.A. 528, "Under such system of accounting receipt of income—actual or constructive—is not essential to constitute income within the statutory definition of income. Under an accrual system of accounting one accrues income, he does not receive it. Under the receipts and disbursements method, one receives income and does not accrue it". (pp. 936, 937)

"From the above expressions, it is apparent that the general definition of 'accrued' is limited when taken in connection with income returns. We may conclude that income has not accrued to a taxpayer until there arises to him a fixed or unconditional right to receive it.

"So far, only the right to receive has been considered. *Must we also consider the prospect of realization on that right by the taxpayer? In other words, when the right to receive arises, should the fact that the right is or is not collectible be taken into consideration in determining whether income has accrued? We believe that no income accrues unless there is a reasonable expectancy that the right will be converted into money or its equivalent.* Commissioner v. Brown, (C.A.A. 1) 54 F. (2d) 563; Corn Exchange Bank v. United States, (C.A.A. 2) 37 F. (2d) 34; Automobile Ins. Co. v. Commissioner (C.C.A. 2) 72 F. (2d) 265, 267; Commissioner v. Brooklyn R. S. Corp. (C.C.A. 2) 79 F. (2d) 833, 834; 1 Paul & Mertens, Law of Federal Income Taxation, 557, §11.73. See, also, American Cigar Co. v. Commissioner (C.C.A. 2) 66 F. (2d) 425, 426, certiorari denied 290 U.S. 699, 54 S.Ct. 209, 78 L.ed. 601; Helvering v. Russian Finance & Construction Corp. (C.C.A. 2) 77 F. (2d) 324, 327.

“The complete definition would therefore seem to be that income accrues to a taxpayer, when there arises to him a fixed or unconditional right to receive it, if there is a reasonable expectancy that the right will be converted into money or its equivalent.” (pp. 937, 938) (Emphasis supplied).

The petitioner also believes that the inapplicability of the so-called Federal control cases upon which respondent relies is quite simply demonstrated by the following language of the Circuit Court in the *Liebes* case where it said as follows:

“Petitioner contends that the income accrued, at the time when the interference by the United States occurred, namely during the years 1891, 1892 and 1893, not on the theory, as we understand it, that the right to receive such income was fixed and unconditional, but on the analogy of *Southern Ry. Co. v. Commissioner*, (C.C.A. 4) 74 F. (2d) 887, and *Helvering v. Gulf M. & N. R. Co.*, 63 App. D.C. 244, 71 F. (2d) 953. In those cases it is held that compensation received by railroads for federal control during the war period accrued proratably over the entire period of control. Those cases are merely examples of the rule. The Federal Control Act (Act of March 21, 1918, c. 25, §1, 40 Stat. 451) fixed the right to receive the income for the entire period of federal control. *Southern Ry. Co. v. Commissioner*, (C.C.A. 4) 74 F. (2d) 887, 893, *supra*; *Continental Tie & L. Co. v. United States*, 286 U.S. 290, 295, 52 S.Ct. 529, 530, 76 L. ed. 1111, although decided under a different act is analogous and is authority for the conclusion reached.” (p. 938)

In the Federal Control cases the certainty of income

was fixed by statute. In our renegotiation case the uncertainty of income was fixed by statute and continued until the statute of limitations barred the effect of the statute.

The petitioner also feels that the analogy between the problem confronting the court in the *Liebes* case as regards the finality of judgment and the right to income during the period in which an appeal might be effected, and the problem confronting this court in the case at bar as regards the actual threat of renegotiation which hung over the head of Harbor Plywood Corporation during the possible period of one year in which renegotiation of P.F.I. might occur, is so strong as to justify the following further quotation from the *Liebes* case relating to the effect of a possible appeal and reversal of judgment upon the right and duty to accrue income. In that connection, the *Liebes* case said, at pages 938-939:

“Fifth. With respect to the action in which petitioner recovered judgment, it seems to be conceded that income therefrom accrued to petitioner in the fiscal year prior to the one ending January 31, 1930, unless the right to receive, fixed by the judgment, was conditional. Respondent contends that the right was conditional, because (1) the judgment might be reversed on appeal, and, therefore, it was not unconditional until the time for appeal had expired, which in such case was in the fiscal year ending January 31, 1930; and (2) there was no appropriation to satisfy the judgment until during the fiscal year ending January 31, 1930.

“Did the right to receive become fixed or unconditional at the time judgment was entered, or when

the time within which an appeal might be taken had expired?

“It is clear that where a claim exists, no income may accrue, in the absence of a settlement, so long as a judgment has not been entered. *Lucas v. American Code Co.*, *supra*, 280 U.S. 445, 450, 50 S.Ct. 202, 203, L.ed. 538, 67 A.L.R. 1010; *North American Oil Consol. v. Burnet*, *supra*, 286 U.S. 417, 423, 52 S.Ct. 613, 615, 76 L.ed. 1197; *United States v. Safety Car Heating & Lighting Co.*, *supra*, 297 U.S. 88, 99, 56 S.Ct. 353, 358, 80 L.ed. 500; *Commissioner v. Brown*, (C.C.A. 1) 54 F. (2d) 563, 567, *supra*; *Buffalo Union Furnace Co. v. Helvering*, (C.C.A. 2) 72 F. (2d) 399; *Commissioner v. Southeastern Express Co.*, (C.C.A. 5) 56 F. (2d) 600; *J. N. Pharr & Sons v. Commissioner*, (C.C.A. 5) 56 F. (2d) 832; see, also, *Commissioner v. John Thatcher & Son*, (C.C.A. 2) 76 F. (2d) 900. *Commissioner v. Highway Trailer Co.*, (C.C.A. 7) 72 F. (2d) 913, is an example where the same principle is applicable. The same may be said for *Board v. Commissioner*, (C.C.A. 6) 51 F. (2d) 73, and *Massey v. Commissioner*, (C.C.A. 7) 51 F. (2d) 76. This rule seems to coincide with what is considered to be proper accounting practice. Ronald, *Accountant's Handbook* (2d Ed.) p. 298.

“Approaching the other end of the process of litigation, we have for consideration the case where the claim has been reduced to judgment but an appeal has been taken. *United States v. Safety Car Heating & Lighting Co.*, *supra*, 297 U.S. 88, 99, 56 S.Ct. 353, 358, 80 L.ed. 500, we believe establishes the rule, namely, that no income accrues until the appeal is determined. Compare *Commissioner v. Brown*, (C.C.A. 1) *supra*; *Commissioner v. John*

Thatcher & Son, (C.C.A. 2) 76 F. (2d) 900, 902, *supra*; *Commissioner v. Southeastern Express Co.*, (C.C.A. 5) *supra*; *Central Trust Co. v. Burnet*, 60 App. D.C. 4, 45 F. (2d) 922, 923.

“As to the situation lying between the two mentioned, that is where judgment is entered, and no appeal has been taken, but the time within which an appeal might be taken has not expired, we find no cases directly in point. If appeal is taken, the right is not fixed until determination of the appeal; and if no appeal is taken, the right is fixed. *We believe in the latter situation that the right becomes fixed on termination of the appeal time.* This seems to coincide with the actual practice of the government, as shown by provisions regarding payment of judgments rendered against the United States. It is usually provided that payment will not be made until the time for appeal has expired. Treasury Regulations 86 and 94, Arts. 322-325; Act March 4, 1933, §2, 47 Stat. 1602, 1616; Act Aug. 12, 1935, §2 (d) 49 Stat. 571, 602.

“With respect to the contention that the absence of an appropriation makes the right conditional, we believe that such fact does not affect the right, but the realization of the right. Even if the judgment remained unpaid, the right would not be impaired. But the absence of an appropriation may be considered in connection with the condition in the general definition hereinabove mentioned, that there must be a reasonable expectancy that the right will be converted into money or its equivalent. Respondent points out that Congress has refused to make an appropriation to satisfy the judgment rendered January 12, 1931 in *Dalton v. United States*, 71 Ct. Cl. 421 (75 Cong. Rec. Part 2

pp. 1233, 1307; 79 Cong. Rec., Part 10, p. 10816). Respondent says, however, that he 'does not wish even to seem to contend that the legislative branch of the government does not usually appropriate moneys to satisfy judgments rendered against the United States'. It is inconceivable that Congress would go through the idle ceremony of enacting a statute authorizing the suits in question, and subsequently render it nugatory by the failure to make an appropriation. We believe that when the appeal time expired, there was a reasonable expectancy that the right would be converted into money.

"In conformity with the foregoing, we hold that income from petitioner's claim on which it recovered judgment, accrued to petitioner during the fiscal year ending January 31, 1930." (pp. 938-939) (Underlining supplied).

So it is in the case at bar. The period of possible renegotiation of P.F.I. is similar to the period of possible appeal from the judgment in the *Liebes* case. During such period of possible renegotiation of P.F.I., Harbor's right to the income was conditioned and could not be accrued. The fact that no renegotiation of P.F.I. occurred does not change the result just as the Court in the *Liebes* case pointed out that the failure to appeal from the judgment makes no difference. Just as the court said "that the right becomes fixed on termination of the appeal time," so here Harbor's right became fixed on termination of the renegotiation time for P.F.I., namely, at the end of the one-year period of limitation.

If actual renegotiation of P.F.I. had been taking place, the situation would have been identical with the

situation discussed in the *Liebes* case of a judgment with an appeal actually taken and pending. As pointed out in the *Liebes* case, *U. S. v. Safety Car Heating & Lighting Co.*, 297 U.S. 88, 99, establishes the rule that no income accrues in such a situation until the appeal is determined. This in effect is the exact situation recently recognized and approved by the Tax Court as regards the effect of actual renegotiation in *Lester C. Smith & Mary B. W. Smith v. Commissioner*, 8 T.C.M. 385 (1949), discussed hereinafter.

The petitioner now submits that the following cases, which take the *Spring City Foundry* rule and amplify and refine it in language as set forth at the beginning of this phase of the argument in the Petitioner's Brief, should be examined. These cases are:

Georgia School Book Depository, Inc. v. Commissioner, 1 T.C. 463 (decided January 19, 1943);

Fifth Street Store, 6 T.C. 644 (1946);

San Francisco Stevedoring Co., 8 T.C. 222 (1947);

Cuba Railroad Co., 9 T.C. 211 (1947);

William Justin Petit, 8 T.C. 228 (1947); and

Lester C. Smith (deceased), Mary B. W. Smith, Testamentary Executrix v. Commissioner, and *Mary B. W. Smith v. Commissioner*, 8 T.C.M. 385 (1949).

Turning then to the first of these cases, *Georgia School Book Depository, Inc.*, 1 T.C. 463, we find a case involving a simple question of whether the taxpayer

which was an accrual basis taxpayer, should have accrued certain school book commissions at the time the books were sold by the publishers to the State of Georgia, or should have returned them as income only when the books were paid for by the State as the petitioner contended. Under the facts there presented the court held adversely to the petitioner and held that the items should be accrued as soon as the books were sold notwithstanding that at that time the State treasury had insufficient funds with which to make the required payment. The Tax Court, however, rightly recognized the existence of "the reasonable expectancy" exception to the *Spring City Foundry* case definition of accrued income and, commenting on that point, the Tax Court used the following language (1 T.C. 463, at pp. 468-9) :

"We pass, then, to the second question, whether there was a reasonable expectancy that the claim would ever be paid. *Where there is a contingency that may preclude ultimate payment, whether it be that the right itself is in litigation or that the debtor is insolvent, the right need not be accrued when it arises.* This rule is founded on the old principle that equity will not require a suitor to do a needless thing. The taxpayer need not accrue a debt if later experience, available at the time that the question is adjudged, confirms a belief reasonably held at the time the debt was due, that it will never be paid. *Corn Exchange Bank v. United States*, 37 Fed. (2d) 34 (2d Cir.) ; *H. Liebes & Co. v. Commissioner*, 90 Fed. (2d) 932 (9th Cir.), and cases there cited at page 937. On the other hand, it must not be forgotten that the alleviating principle of 'reasonable expectancy' is, after all, an excep-

tion, and the exception must not be allowed to swallow up the fundamental rule upon which it is engrafted requiring a taxpayer on the accrual basis to accrue his obligations, *Spring City Foundry Co. v. Commissioner, supra*. If this were so, the taxpayer might at his own will shift the receipt of income from one year to another as should suit his fancy. Cf. *Clifton Manufacturing Co.*, I.T.C. 71. *To allow the exception there must be a definite showing that an unresolved and allegedly intervening legal right makes receipt contingent or that the insolvency of his debtor makes it improbable.* Postponement of payment without such accompanying doubts is not enough. * * *." (pp. 468-469) (Underlining supplied).

The court then went on to comment upon and quote with approval much of the language of the *Liebes* case which the petitioner has set forth in this brief above.

Following the language of the *Georgia School Book* case, the petitioner, Harbor Plywood Corporation, asserts that in the case at bar "there is a contingency that may preclude ultimate payment," which affected petitioner's right to this income, namely, the very real contingency at the times in question that all of P.F.I.'s income could and might be renegotiated. Such a contingency could not possibly be eliminated prior to the expiration of the statute of limitations on the renegotiability of P.F.I. Further, Harbor Plywood asserts that there was "a definite showing that an unresolved and allegedly intervening legal right makes receipt contingent * * *," and that such intervening legal right was the Renegotiation Act of Congress itself which

superimposed a legal condition upon Harbor's right to receive this income until it was barred by the statute of limitations. The condition imposed by the Act of Congress was reinforced by the affirmative act of P.F.I. itself in issuing each credit memorandum conditionally by making it specifically "subject to renegotiation."

In passing it might be well to note that the Tax Court, in the case of *Fifth Street Store*, 6 T.C. 664 (1946), used the following language to define accrued income (p. 679):

"But in order for a claim to be accruable, both the liability and the amount must be certain at the time or sufficiently ascertainable. *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182; *Lucas v. North Texas Lumber Co.*, 281 U.S. 11; *H. Liebes & Co. v. Commissioner*, (C.C.A., 9th Cir.), 90 Fed. (2d) 932."

In the *San Francisco Stevedoring* case is to be found the following language:

" * * * A taxpayer, using an accrual method of accounting, must accrue an item in the year in which the taxpayer acquires a fixed and unconditional right to receive the amount, even though actual payment is to be deferred. There must be no contingency or unreasonable uncertainty qualifying the payment or receipt. Income does not accrue to a taxpayer using an accrual method until there arises in him a fixed or unconditional right to receive it. *United States v. Anderson*, 269 U.S. 422; *Continental Tie & Lumber Co. v. United States*, 286 U.S. 290; *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182; *United States v. Safety Car Heating & Lighting Co.*, 297 U.S. 88; *Putnam's*

Estate v. Commissioner, 324 U.S. 393; *H. Liebes & Co. v. Commissioner*, 90 Fed. (2d) 932; Mertens Law of Federal Income Taxation, Sec. 12.60. The time when an item accrues is largely a question of fact, to be determined in each case. It is hereby found as an ultimate fact, that the item here in question did not accrue in 1939." (pp. 225-226)

And, it is well to continue this quotation, in part, so far as it is relevant to the case at bar, and point out that even where the amount may be fixed (and, of course, the exact amount was not fixed in the case at bar because of the threat of renegotiation) that does not determine that the amount shall be accrued. On that point the *Stevedoring* case uses the following language:

"It could not have been said in 1939 that there was *no contingency or unreasonable uncertainty qualifying the payment to the petitioner of the amount in question*. Coast had apparently supplanted San Francisco to the extent, at least, that San Francisco no longer needed this surplus of \$145,000. If San Francisco had been liquidated at that time, all of the \$145,000 would have been paid to members of San Francisco who were also members of Coast. Coast needed this money in order to carry on the labor relations of those members. *The amount which the petitioner was to get was fixed, but, so far as this record shows, it was not only uncertain in 1939 as to just when Coast would pay the money to the petitioner, but it was also uncertain as to whether it would ever pay it*. It is stated in the stipulation of facts that Coast needed the money to carry on its activities more effectively and to replace the 'existing deficit' in its treasury. If it did not realize income, it would not be able

to make the payments. * * *'' (p. 226) (Emphasis supplied)

In the case at bar not only was the exact amount not fixed but also it was uncertain, until the period of limitations on renegotiation had expired, as to whether P.F.I. would ever pay and P.F.I. had made such uncertainty emphatically known to the taxpayer by issuing each credit memorandum "subject to renegotiation."

The *Cuba Railroad* case, 9 T.C. 211 (1947) is to the same effect as the *Stevedoring* case and holds that a taxpayer using an accrual method of accounting does not have to accrue an item where it appears at the end of the taxable year that there is real doubt as to the collectibility of the item. In the brief opinion of the Tax Court in the *Cuba Railroad* case the language from the *Stevedoring* case quoted above was quoted with approval and it was pointed out that even though the amount may be fixed, where there is uncertainty as to whether the amount would ever be paid, it need not be accrued until the uncertainty is removed in some way. In the case at bar such uncertainty could not be eliminated until the period for renegotiation of P.F.I. had expired.

Following the *Stevedoring* case we find another recent Tax Court decision analyzing the concept of accrued income. It is *William Justin Petit*, 8 T.C. 228 (1947) where the following language appears at page 233 of the opinion:

"When a taxpayer is on the accrual basis it is the right to receive the income and not the actual receipt that determines the inclusion of the amount

in gross income. *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182. However, in order for items to be accrued as income the event must occur which determines the amount due. When the amount to be received depends upon a contingency or future events, it is not to be accrued until such contingency or the events have occurred and fixed with reasonable certainty the fact and amount of income. *U. S. Cartridge Co. v. United States*, 284 U.S. 511." (p. 233)

Shortly after the *Cuba Railroad* case was decided the language quoted above from the *William J. Petit* case was quoted with approval by the Tax Court in the case of *Luckenbach Steamship Co.*, 9 T.C. 662, at page 675. Precisely as is pointed out in the quoted language above, in order for items to be accrued the event must occur which determines the amount due, and, as pointed out above, the event which had to occur to determine the amount due the petitioner by P.F.I. was the expiration of the period for possible renegotiation of P.F.I. Until that event occurred the amount due the taxpayer was not fixed with any degree of certainty and hence could not be accrued.

This abbreviated chronology of the development of the true rule of accrued income brings the petitioner to the last case in the sequence, namely, *Lester C. Smith (deceased), Mary B. W. Smith, Testamentary Executrix, v. Commissioner and Mary B. W. Smith v. Commissioner, supra*. It is true that the taxpayer in that case was a cash basis taxpayer rather than an accrual basis taxpayer, but it is submitted that this case, because it is the only case which the petitioner has been

able to find dealing with the Renegotiation question here in issue, is particularly pertinent. Especially is this so when the concept of constructive receipt as applied to a cash basis taxpayer is not greatly different from the concept of accrual as applied to an accrual basis taxpayer.

In that case the taxpayer, an employee, executed an agreement with the partnership by which he was employed, under the terms of which he was to receive a base salary plus 12.19% of the profits, subject to maintenance of reserve for losses at a specified level. During the years 1942 and 1943 the partnership was engaged in the construction of maritime facilities under contracts which were subject to profits' Renegotiation. Renegotiation was in process in 1943 and was not concluded until 1946. During 1943, the taxpayer's share of profits in such contracts was included in other credits to a special account on the employer's books in which the employee's 12.19% share of profits was recorded. Certain amounts were withdrawn by the employee—taxpayer and a portion of the balance was required to be maintained as the taxpayer's share of the loss reserve. By agreement of the parties the excess of the amount credited to the special account over withdrawals was not to be withdrawn until the conclusion of Renegotiation fixed definitely the amount of the taxpayer's 12.19% share in the profits from the contracts being Renegotiated. The Commissioner in that case, just as in the case at bar, contended that this balance had been constructively received in 1943 and was therefore includable in the taxpayer's income for that year. The Tax

Court, however, in that case, in curious contrast to the attitude in this *Harbor Plywood Corporation* case at bar, refused to sustain the Commissioner and held that the agreement restricting the withdrawal was to be given equal consideration with the agreement giving the taxpayer a 12.19% share of the profits, and, since it had been proven that there was such an agreement restricting withdrawals in the year 1943 (just as there were restrictions limiting Harbor Plywood's right to withdraw the funds from Pacific Forest Industries by virtue of the credit memorandums being issued, as The Tax Court properly found, "subject to Renegotiation" in each year) there was no constructive receipt of additional compensation in that year. It is submitted that a more analogous case in support of the petitioner's alternative contention in the case at bar could hardly be found and that the *Smith* case, together with the *Liebes* case, is all that this Court needs to hold in favor of the petitioner's alternative contention. It should also be noted that in the *Smith* case the Tax Court addressed itself, and quite properly so, only to the taxpayer-employee's method of accounting and the opinion makes no mention of whether the amounts so credited to the employee's account were claimed and allowed as a deductible salary expense by the employer. It is to be assumed from the analysis of the employee's account on the employer's books, as set forth in the opinion, that the employer claimed and was allowed a deduction for the employee's share in the profits, subject to Renegotiation, notwithstanding the fact that until such Renegotiation was completed there was no figure against

which the employee's percentage could positively apply and hence there was no exact amount of income to which the employee had an unconditional right. As far as the impact of Renegotiation in the *Smith* case and in the case at bar is concerned, it seems equal in force in both cases and the fact that in one the taxpayer was a cash basis taxpayer and in the other the taxpayer was an accrual basis taxpayer would seem, so far as such impact of Renegotiation was concerned, to be a distinction without a difference. So, too, the fact that in the *Smith* case the Court was concerned with an actual Renegotiation and that the case at bar involves a threatened and probable (not merely possible) Renegotiation is, too, a distinction without a difference. It is interesting to note that nowhere in the opinion of the Tax Court in the case at bar was any reference made to the *Smith* case nor was any attempt made to distinguish it (notwithstanding that such case was cited emphatically by petitioner). Petitioner respectfully submits that the doctrine of the *Liebes* case and of the *Smith* case can and should be applied to the case of the taxpayer here, Harbor Plywood Corporation.

Stated simply, this Court should reaffirm the principle and apply it to the facts which have been found and this Court should hold that where an accrual basis taxpayer is due to receive an uncertain amount, if any, from another corporation, which other corporation is threatened with Renegotiation of its income under the Renegotiation Act, such taxpayer has no fixed or unconditional right to a determinable amount of income; and, further, that there is no reasonable expectancy,

even if the right is found to exist, the right will be converted into money or its equivalent until that contingency of Renegotiation, which may preclude ultimate payment and which arises by operation of Congressional enactment and by the continued persistent and active written and oral threats of those administering such act, is eliminated or barred by the period of limitations governing such Renegotiation. Just as in the *Liebes* case the right to the income did not become fixed until the period for appeal from the judgment in favor of the taxpayer had expired, so, too, here the right to the income had not become fixed until the Government's right to renegotiate the income of Pacific Forest Industries had expired under the applicable one-year period of limitations.

The rule of law asserted by the petitioner at the opening of this part A of the Argument is, it is submitted, an accurate statement of the true rule of accrued income. It is amply supported by the *Liebes* case decided by this Ninth Circuit Court, by the leading United States Supreme Court and other Federal Court decisions cited in detail in the *Liebes* case, and by the leading text authorities such as Mertens, "Law of Federal Income Taxation," Vol. 2 (and 1950 Cum. Pocket Supp.) §§12.60-12.65; §§12.75-12.77; Rabkin and Johnson, "Federal Income, Gift and Estate Taxation," pp. 704, 707-8, 709b, 712. To the same effect is an early ruling of the Bureau of Internal Revenue, L.O. 1086, 1-1 CB 87. When properly applied to the facts in this case, this true rule of accrued income supports the taxpayer's alternative contention and justifies reversal of the Tax Court.

B.

The Tax Court erred in its opinion in stating that the threat of renegotiation was a “mere possibility of renegotiation”. Such statement is contrary to the evidence. Such renegotiation was not only possible but highly probable. (Assignment of Error III.)

The problem before this court arises from Treasury Procurement's threats to renegotiate all of Pacific Forest Industries' contracts during the tax years in question. That such threatened renegotiation was actual, strong, continued and definite there can be no doubt (See Joint Ex. 5-E (R. 57), 7-G (R. 64), 8-H (R. 70) and 11-K (R. 77)). Because the Treasury Department had asked and continued to ask for Renegotiation, it was not only possible but highly probable.

Pacific Forest Industries emphatically asserted at all times, both by correspondence and by personal conferences with the Chairman of the Treasury Department Price Adjustment Board by Pacific Forest Industries' General Manager and legal counsel, that it was not subject to renegotiation under the Renegotiation Act. (See Joint Ex. 7-G (R. 64)), and testimony of Mr. Schweppe (R. 111, 113). In spite of its repeated and emphatic assertions to the contrary, Pacific Forest Industries was told by the Treasury Department Procurement Division, in person and by letter (R. 65), that it was subject to renegotiation and, further, that it was required to submit certain data and annual reports in relation thereto. Note in particular the emphatic statement to be found in the letter dated June 4, 1943, from the Chairman of the Treasury Department Price Ad-

justment Board to Pacific Forest Industries (Joint Ex. 7-G (R. 64-66)), wherein it was said:

“Reference is made to your letter of April 24, 1943, in which you state that Pacific Forest Industries is exempt from income tax payments through the Board of Tax Appeals in Docket No. 99742 dated November 4, 1941.

“After a review of the Docket mentioned Procurement Division’s Legal Staff has advised that the opinion rendered by the Board of Tax Appeals in this case only indicates a certain sum of money received by the contractor from its producer mills for the purpose of reducing an operating deficit incurred in its prior fiscal year was excludable from gross income for that taxable year. Hence, it appears that the Docket opinion is no basis to exempt your company. Consequently, *I am directed to require that your accounts be renegotiated.*” (Emphasis supplied)

Treasury Procurement insisted that because P.F.I. was the only party to the contract, it was the only party to be recognized by Treasury Procurement and that it was, therefore, subject to renegotiation under the Renegotiation Act.

The petitioner wishes also to stress the fact that Pacific Forest Industries could derive no particular comfort from the letter from the Treasury Department Price Adjustment Board dated June 21, 1944 (Joint Ex. 11-K (R. 77)). That letter indicated that there would quite probably be no renegotiation for Pacific Forest Industries’ fiscal year ending March 31, 1944 (not 1943 as erroneously stated in the letter, which dis-

crepancy is clarified by an examination of Joint Exs. 12-L (R. 79) and 13-M (R. 80)) because such letter went on to state that it was not a release of liability under the renegotiation statute. This left the threat of renegotiation hanging not only over the head of Pacific Forest Industries but over the heads of all of the members of Pacific Forest Industries as to export sales. It is, therefore, understandable and reasonable that Pacific Forest Industries should have been advised by its legal counsel, under date of June 27, 1944 (Joint Ex. 14-N (R. 81)) that no payments could be made by Pacific Forest Industries to its members until Pacific Forest Industries' liability for possible renegotiation was terminated by the applicable period of limitations on such renegotiation (Also see Mr. Schweppe's testimony, R. 22). Petitioner, Harbor Plywood Corporation, had full knowledge of the threatened renegotiation and approved of the delay in payment advised by counsel (R. 114-116).

It is submitted that under these circumstances both Pacific Forest Industries and the petitioner, Harbor Plywood Corporation, had ample reason for believing that Pacific Forest Industries might be subject to renegotiation and that, therefore, until either renegotiation was complete, or the statute of limitations had expired on renegotiation, the income of Pacific Forest Industries was not fixed and determined as to amounts and the petitioner, Harbor Plywood Corporation, had no fixed, unconditional and absolute, right to a refund of any portion thereof under any interpretation of the Internal Revenue Code or Regulations.

It is apparent, from the record in this case, to which reference is made above, that the threat of renegotiation was far more than a "mere possibility of renegotiation" as stated by the Tax Court in its opinion (R. 130). Such threatened renegotiation was actual, strong, continued, persistent and definite. There is no doubt as to that. Such renegotiation was highly probable. As stated in the dissenting opinion of Tax Court Judge Disney (R. 132-133):

"Obviously it was a probability for the Treasury Department had asked for it. The result of renegotiation was altogether problematical and contingent. In my opinion the taxpayer upon the accrual basis should not be required to accrue such an uncertain and contingent item."

While referring to portions of the majority and minority opinion on the degree of the " * * * possibility of renegotiation," another error of both law and fact by the Tax Court is readily apparent and requires correction on appeal by this Circuit Court.

Petitioner wishes to invite this Court's attention to the following strange language used by the Tax Court majority in its opinion below in the case at bar (R. 130):

" * * * There was no contingency as to the amount of income represented by the credit memorandums or of Pacific's right to receive it; *nor was there any contingency as to petitioner's right to whatever income might remain after renegotiation, should that occur.* The mere possibility of renegotiation did not give rise to a liability which either Pacific or the petitioner could have accrued on its books,

since it had not become fixed and was being strenuously protested by Pacific. No liability for renegotiation was set up in Pacific's books. *Conceding that there was a possibility of renegotiation, there was no way of even approximating the amount of excessive profits that might be claimed by the Government.*" (Italics supplied)

It is readily apparent that the quoted language is confused, illogical and contradictory. The use of the words " * * * whatever income might remain after renegotiation * * *" indicates that the Tax Court recognized that until Renegotiation was barred by limitations the exact dollar amount which Harbor Plywood would receive from P.F.I. was not only uncertain and indefinite but also might be zero.

But the Tax Court in stating " * * * nor was there any contingency as to petitioner's right to whatever income might remain after renegotiation * * *" was really saying, in effect, was it not?:

"Harbor Plywood had an unconditional right to an indefinite dollar amount which could vary all the way from the face amount of the credit memo down to and including zero, depending on the results of the Renegotiation of P.F.I. or on the expiration of the period of limitations on Renegotiation."

The result of renegotiation was completely problematical and contingent. That being so, petitioner fails to see how the Tax Court could logically render the decision which it did on the accrual of income by Harbor Plywood.

So, too, the second underlined portion of the above

quotation of the Tax Court language argues more strongly for the taxpayer's contention than for the Tax Court's opinion when it says that so long as there was a possibility of renegotiation " * * * there was no way of even approximating the amount of excessive profits that might be claimed by the Government." With this the petitioner agrees. During the period of possible renegotiation there was absolutely no way of computing what amount, if any, would be left for distribution by P.F.I. to Harbor Plywood and to the other stockholders holding the credit memorandums. Hence the amounts represented by such credit memos could not be accrued as income.

Meaning no disrespect to the Tax Court, the petitioner is completely at a loss to understand the fallacious reasoning of the Tax Court quoted above. Logically, it just does not support the decision rendered. Stated otherwise, it simply "puts the cart before the horse." Profit on the sales by P.F.I. to the Government for Lend-Lease (the Renegotiation of which profits, as the quoted language states, " * * * was being strenuously protested by Pacific.") had to be income first to Pacific Forest Industries before it could become income to Harbor Plywood, and not *vice versa* as the Tax Court seems to believe. With " * * * whatever income might remain after renegotiation * * *" being uncertain, indefinite and incapable of mathematical computation, and with there being absolutely "no way of even approximating the amount of excessive profits that might be claimed by the Government," how are the requirements for accruing income by Harbor Plywood satis-

fied? The true rule defined at the outset of this portion of the brief is violated in every respect by the quoted uncertainties.

Moreover, it is plain the Tax Court was badly confused in another particular when it said:

“The mere possibility of renegotiation did not give rise to a liability which * * * the petitioner could have accrued on its books since it had not become fixed and was being strenuously protested by Pacific.”

Of course there could be no liability by the petitioner, Harbor Plywood, but not for the reason given by the Tax Court. The reason is, we are concerned only with gross income accrual by petitioner; we are not concerned with expense deductions or liability accruals by petitioner. As to Harbor Plywood, the credit memos presented a problem of gross income accrual and not liability accrual. And, as pointed out hereafter in part D of the Argument, whether P.F.I. could not have or did not set up a liability for renegotiation is not in issue in this case and does not determine or control the petitioner's time for accruing income.

C.

The Tax Court erred in relying on the cases dealing with patronage dividends by cooperatives (R. 131), none of which cases were concerned with a threatened or actual renegotiation of a cooperative's income under the Renegotiation Act of 1942. (Assignment of Error VI.)

None of the cases set forth in the opinion of the Tax Court, namely, *San Joaquin Valley Poultry Producers*

Association, 136 F.(2d) 382; *Midland Cooperative Wholesale*, 44 B.T.A. 824; *United Cooperatives, Inc.*, 4 T.C. 93, involved the unique problem which is before this Court, namely, the renegotiation of a co-operative's income. Because of such possible and probable renegotiation, Pacific Forest Industries' right to income from Lend-Lease was as uncertain, conditional and contingent upon there being no renegotiation as was the taxpayer's right to its share in such income; Pacific Forest Industries' right to its income might, in the language of the *Liebes* case, be "reversed by appeal" so to speak, that is, reversed by Renegotiation. As demonstrated above, petitioner, Harbor Plywood Corporation, could not accrue such income from Pacific Forest Industries until the contingency of P.F.I.'s renegotiation was eliminated. To hold otherwise, as to the petitioner, Harbor Plywood Corporation, would be to raise Harbor Plywood Corporation's right to such income to a higher degree of certainty and to a more reasonable degree of expectancy than the source of such income itself. When so considered, from the standpoint of the only taxpayer who is a party to this litigation, namely, Harbor Plywood Corporation, the matter is reduced to an absurdity and the inapplicability of the patronage dividends' case is immediately apparent. If the co-operative's right to income was uncertain, conditional and contingent, how can the members of the co-operative possibly have a share in such income which is certain, unconditional and not contingent? To ask the question is to answer it. Such a situation is, of course, logically impossible and the co-operative, Pacific Forest Industries,

recognized this when it took affirmative action, as it was legally authorized to do, in specifically providing that its members share in such income was to be uncertain, conditional and contingent by issuing each credit memorandum, as the Tax Court properly found, "subject to renegotiation."

D.

The Tax Court erred in considering that the method of accounting and the time for deducting expenses by Pacific Forest Industries is in any way determinative of the method of accruing and the time for reporting income by the taxpayer, Harbor Plywood Corporation. (Assignment of Error V.)

The Tax Court further erred in failing to recognize that, notwithstanding that the taxpayer, Harbor Plywood Corporation, is an accrual basis taxpayer, certain of the concepts in cases decided under the principle of "constructive receipt" of income by cash basis taxpayers are relevant and persuasive by way of analogy to the case at bar. (Assignment of Error VII.)

The Tax Court seems to derive some comfort from its statement (R. 130) "no liability for renegotiation was set up in Pacific's books." and in its statement that the income represented by the credit memoranda "* * * had been credited to the petitioner on the books of Pacific when the credit memorandums were issued."

The petitioner respectfully invites this court's attention to the fact that Pacific Forest Industries is not a party to this litigation; the tax reporting of Pacific Forest Industries' income is not an issue and is not relevant to this inquiry, just as in the recent *Lester Smith*, case, *supra*, the employer's income and deduc-

tions were not in issue and were not considered. In the agreed stipulation of facts submitted to the Tax Court the petitioner reserved the right to object to the relevancy of the manner in which Pacific Forest Industries handled these amounts represented by the credit memorandums on its books of account (R. 28); and the Petitioner's counsel renewed its objection to the relevancy of paragraph 9 of the Stipulation of Facts at the time the case was tried to the Tax Court (R. 90-91), but this objection was overruled by the court. Petitioner submits the overruling of this objection was an error and submits further that Paragraph 9 of the Stipulation of Facts is *not* relevant to the case at bar. Harbor Plywood, the petitioner here, stoutly insists that Pacific Forest Industries' method of tax accounting of these particular credits which were subject to threatened renegotiation is in no way determinative of Harbor Plywood's method of reporting income. It is further submitted that a deduction or an exclusion from gross income by an accrual basis taxpayer has been squarely held not of itself to justify the application of the constructive receipt theory of reporting income to a cash basis payee, *Helvering v. Jane Holding Corporation* (C.C.A. 8) 109 F.(2d) 933; similarly, authorized but unpaid salaries by a corporation, were not taxable to a cash basis employee although the corporation kept its books upon the accrual basis and took a deduction for the salary authorized, *Bluthenthal*, 1 B.T.A. 173; and to the same effect *Karr*, 2 B.T.A. 635; *Greenbaum*, 2 B.T.A. 979; and *Farr*, 3 B.T.A. 110. These principles concerning constructive receipt reporting by cash basis

payees and their relation to another taxpayer, regardless of that other taxpayer's method of accounting, are equally applicable to accrual basis payees such as Harbor Plywood Corporation, the petitioner herein. (Constructive receipt is, in effect, what might be termed the accrual basis exception which is applied against cash basis taxpayers in certain circumstances and in particular with reference to wages which have been unconditionally credited to their account without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is made.) The principles in the foregoing cases simply add up to the proposition and rule that one taxpayer's method of reporting income is in no way related to nor determinative of a second and independent taxpayer's method of reporting income.

E.

The Tax Court erred in failing to realize and to find that, in addition to the fact that Pacific Forest Industries issued each credit memorandum "subject to renegotiation," no reasonable expectancy that the right represented by such memorandum would be converted into money could exist so long as the unresolved and intervening legal right as was created by the Renegotiation Act itself was not barred by the Statute of Limitations. (Assignment of Error IX-b.)

The Renegotiation Act itself created an independent supervening factor and established an unresolved and intervening legal right which prevented the creation of any reasonable expectancy that the right represented by the credit memorandum would be converted into

money until the statute of limitations on Renegotiation had run. By its enactment Congress had attached a contingent legal liability on Pacific Forest Industries' claims against the Government in which the petitioner, Harbor Plywood Corporation, hoped ultimately to share. Such liability, created by the supervening Renegotiation Act, imposed a definite condition on the credit memorandum in addition to that imposed by Pacific Forest Industries itself at the time of the issuance of the credit memoranda. It is submitted, therefore, that such credit memoranda were not unconditionally payable and that no enforceable legal action could have been maintained by Harbor Plywood Corporation against Pacific Forest Industries to collect these credit memoranda immediately after their issuance because such claims were not liquidated as to amount nor unconditionally payable. Not being immediately enforceable or collectible, they are certainly not includable in the petitioner's income until they are enforceable or collectible. Stated otherwise, until the act was barred by the period of limitations there was a contingency which might preclude ultimate payment, namely, the possible and probable Renegotiation of Pacific Forest Industries, and there was no reasonable expectancy that the right could be converted into money or its equivalent until passage of the period of limitations. Recognizing this fact, none of the nineteen member corporations brought any actions to enforce payment. No demands were even made. All members recognized the Renegotiation possibility and ratified and approved Pacific Forest Industries' action in delaying payment (R. 115-116).

F.

The Tax Court erred in failing to find that the credits from Pacific Forest Industries were not taxable income to the taxpayer, Harbor Plywood Corporation, until paid in cash. (Assignment of Error IX.)

The petitioner's primary contention is that the amounts represented by the credit memorandums were not income until actually paid in cash notwithstanding that the period of limitations on Renegotiation of Pacific Forest Industries expired prior to the dates of payment. This assertion is made because superimposed upon the threat of Renegotiation was the long delay in payment to Pacific Forest Industries by the Government on Lend-Lease contracts, which delay, in turn, delayed the payment by Pacific Forest Industries to its members (R. 116-117, 121-122; see also Exhibit 18-R (R. 100)). Therefore, until such funds had been received by Pacific Forest Industries, the petitioner, Harbor Plywood Corporation, had no right thereto. See *Weil v. Commissioner* (C.C.A. 2) 173 F.(2d) 805, affirming 5 T.C.M. 279.

G.

The Tax Court erred in failing to find, in the alternative, under the true rule of accrued income set forth above that when the credit memoranda were issued, the taxpayer had no fixed and unconditional right to the amount of each memorandum because at each such time

(a) there was a contingency which might preclude ultimate payment, namely, the possible and probable renegotiation of Pacific Forest Industries;

(b) No reasonable expectancy that the right would

be converted into money could exist so long as such unresolved and intervening legal right as was created by the Renegotiation Act itself was not barred by the statute of limitations; and

(c) There was a further contingency which precluded payment imposed by Pacific Forest Industries itself, namely, the fact that it notified the taxpayer in writing, as The Tax Court properly found for each year, that each credit memorandum was issued "subject to Renegotiation";

and therefore, the amounts represented by said credit memoranda could not be accrued as taxable income by the taxpayer, Harbor Plywood Corporation, until the statute of limitations barred the Renegotiation of Pacific Forest Industries' income. (Assignment of Error IX.)

H.

The Tax Court erred in making and entering its decision of April 25, 1950. (Assignment of Error VIII.)

In support of this, and by way of an end to this Argument, petitioner re-advances all arguments made in parts A through G of this Argument.

CONCLUSION

In conclusion the petitioner wishes to add, and request, that this Court turn back the clock to the dates in question as indicated on the various exhibits in the Record. The decisions made by Pacific Forest Industries and by the taxpayer as to the time and method of payment of the amounts represented by the credit memoranda and the method of reporting them as income were not conceived with any bad faith or with any *quasi* tax-evading motives. This was not merely a fancy device, conceived either with the blessing of unusual foresight or with the benefit of actual hindsight, to shift these items of income to more favorable tax years. The whole history of these Pacific Forest Industries memoranda, the repeated considerations given to the Renegotiation problem by Pacific Forest Industries' executive committee and by the petitioner as well as by the attorney for both parties, clearly indicates that a sincere, honest, intelligent and sensible business attitude was taken by Pacific Forest Industries and by the petitioner. Business judgment buttressed by sound legal and accounting advice given at an early date were the reasons for delay in payment and delay in reporting income. All considerations of the Renegotiation problem, the delays in collection from the Government, the problem of the statute of limitations on Renegotiability, the limitations attached to the issuance of each credit memorandum, and the decisions as to the reporting of income by the petitioner were first made in complete good faith in the war years at a time when it appeared to even the most optimistic observers that the

war, the Renegotiation of Government contracts, and the imposition of high corporate taxes would continue for several years more. The delay in petitioner's reporting these credits as income was not prompted by some subtle scheme to move these items ahead in the years where the tax benefit to the petitioner would be greater. That, thanks to the Atom Bomb, and other fortunate events of history, the war ended more quickly and excess profits taxes were repealed sooner than had been hoped for, were circumstances not foreseen by the petitioner or by Pacific Forest Industries or, it is submitted, by anyone else of intelligence, in the dark years of 1943 and 1944. That the petitioner's method of reporting these credits on a cash basis, or even the alternative method of reporting them as income one year after their issuance, namely, when the period of limitations had run on Renegotiations, should produce tax benefits to the petitioner, is fortuitous and coincidental; it was not premeditated, prophesied or even remotely hoped for when the first decisions were made in 1943 and 1944 as to the proper tax method of paying and reporting such items as income, and therefore, should not be taken into account in any way in determining the result of this case.

For the reasons hereinbefore stated, it is respectfully submitted that the errors and omissions of The Tax Court of the United States be corrected and that The Tax Court of the United States be directed to enter an order in this case at bar of either (1) "No deficiency"; or, in the alternative, (2) to compute the correct deficiencies, if any, for each of said years in question in

accordance with the decision of this Court that the amounts represented by the credit memoranda issued by Pacific Forest Industries to Harbor Plywood Corporation were taxable to Harbor Plywood Corporation and should have been accrued by it as taxable income in the years when the statute of limitations barred Renegotiation of Pacific Forest Industries, and not before.

Respectfully submitted,

WARREN A. DOOLITTLE
Attorney for Petitioner.

APPENDIX A

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code:

“SEC. 22. GROSS INCOME.

“(a) General Definition — ‘Gross income’ includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *”

* * *

“SEC. 41. GENERAL RULE.

“The net income shall be computed upon the basis of the taxpayer’s annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *”

“SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

“(a) General Rule—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period. In the case of the death of a taxpayer whose net income is computed upon the basis of the accrual method of accounting, amounts (except amounts includible in computing a partner’s net income under section 182) accrued only by reason of the death of the taxpayer shall not be included in computing net income for the period in which falls the date of the taxpayer’s death.”

Regulations 111:

“Sec. 29.22(a)-1. What Included in Gross Income—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. * * *”

* * *

“Sec. 29.22(a)-5. Gross Income from Business—In the case of a manufacturing, merchandising, or mining business, ‘gross income’ means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside

operations or sources. In determining the gross income subtractions should not be made for depreciation, depletion, selling expenses, or losses, or for items not ordinarily used in computing the cost of goods sold.”

* * *

“Sec. 29.41-1. Computation of Net Income—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer’s income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See sections 29.42-1 to 29.43-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.”

“Sec. 29.42-1. When Included in Gross Income—
(a) In general—Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless

they are included as of a different period in accordance with the approved method of accounting followed by him. * * *”

* * *

“Sec. 29.42-2. Income Not Reduced to Possession—Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition. A book entry, if made, should indicate an absolute transfer from one account to another. If a corporation contingently credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt.”